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October 24, 2000

The Honorable William E. Kennard
Chairman
Federal Communications Commission
445 Twelfth Street, S.W.
Room 8B201
Washington, D.C. 20554

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OCT 25 2000

Federal Communications Commission
Office of Secretary

Re: Applications Of America Online, Inc., and Time Warner Inc. for Transfers of Control (CS Docket No. 00-30)
***Ex Parte* Letter**

Dear Chairman Kennard:

The undersigned file this *ex parte* letter in response to the October 19, 2000, filing of America Online, Inc. and Time Warner Inc. ("Applicants").[1] Contrary to Applicants' contentions, IM today, in the absence of interoperability, is *not* robustly competitive, is *not* free of barriers to entry or innovation, and *does not* offer consumer choice. In fact, as we explain below, AOL so dominates the IM marketplace that the market has tipped in its favor, stifling competition and making it difficult for competing IM service providers ("IM Competitors") even to survive.

1. AOL's overwhelming market share, its unprecedented anticompetitive behavior, and its demonstrated ability to foist its IM platform on competitors and providers of next-generation IM-enabled devices all prove that the IM market has tipped in AOL's favor.

Despite AOL's continued confused (and confusing) facts and figures relating to the number of AOL IM users, AIM users, and ICQ users, and the relevant number of IM customers of competing IM providers, the fact remains that AOL has over 80-90% of the IM actual users and traffic and a customer base that is over 10 times greater than the base of its nearest rival. The numbers, when analyzed correctly, clearly reveal that the market has "tipped" toward AOL, the dominant IM provider.

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[1] Notice of *Ex Parte* Presentation in CS Docket No. 00-30 of Peter D. Ross, Wiley, Rein & Fielding, at 2 (Oct. 19, 2000) ("October 19 *ex parte*").

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But the Commission need not focus only on the numbers to establish AOL's dominance in the IM market. AOL's dominance can be seen clearly through AOL's behavior.

A. AOL's Blocking Behavior

AOL has maintained and expanded its dominant position in the IM market by steadfastly blocking any other IM provider seeking to interoperate:

- Recognizing the importance of inter-communication among IM users, the undersigned and other IM Competitors – including Prodigy Communications, Microsoft, and AT&T – worked tirelessly to develop applications that would allow their users to exchange instant messages with AIM users.[2]

- Within hours after each IM Competitor released an application that would enable its customers to inter-communicate with AOL's customers, AOL's engineers electronically jammed all instant messages received from outside its network.

- When IM Competitors altered their software to restore interoperability, AOL again revised its software to block it, prompting an AOL spokesperson to declare proudly, "We know how to block things."[3]

- This process has been repeated numerous times throughout the past year; although some IM Competitors have abandoned their efforts to interoperate with AOL's system, others continue to work toward developing interoperable applications.[4]

B. AOL's Licensing Behavior

AOL has made numerous statements to Congress, the Commission, and the public touting the fact that it will license its IM technology royalty-free to anyone who asks.[5]

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[2] IM Competitors do not want access to AOL's customer base for marketing purposes; IM Competitors work to develop interoperable applications in an effort to create a way for all IM users to communicate with one another.

[3] *See* Rajiv Chandrasekaran, *Clash of the Titan Erupts over AOL's Instant Messaging*, Wash. Post, July 24, 1999, at A01.

[4] *See* Don Clark, *Microsoft Ends Row With AOL Over Messaging*, Wall St. J., Nov. 18, 1999, at B13.

[5] *See, e.g.*, *Hearing on Interactive Television Before the House Subcomm. on Telecommunications, Trade, and Consumer Protection*, 106th Cong., at 44 (Sept. 27, 2000) (statement of Steven Case, Chairman and CEO, America Online, Inc.) ("[A]t least a dozen companies have entered into [royalty-free licenses] and other companies are welcome to do that."); *id.* at 45 (statement of Gerald M. Levin, Chairman and CEO, Time Warner Inc.) (explaining that royalty-free licenses are not a business proposition); *En Banc Hearing on America Online, Inc. and Time Warner Inc. Applications for Transfer of Control in CS Docket No. 00-30 Before the Federal Communications Commission* (July 27, 2000) (statement of Steven Case) (explaining that (continued...)

However, AOL has rebuffed efforts of several IM Competitors to engage in negotiations that would allow interconnection among IM users. For example:

- Notwithstanding numerous good faith attempts to work with AOL, Prodigy has not been able to obtain a licensing arrangement with AOL.

- Other IM Competitors, including Odigo, have attempted to secure licensing agreements and have been completely ignored by AOL.

The fact that the IM Competitors all focused their efforts on AOL and not other providers itself demonstrates AOL's dominance. Interoperability with another 5 percent provider is frankly of little value; rather, survival depends upon interoperability with AOL. Even in AOL's absence, however, the IM Competitors have worked diligently on interoperability standards issues, but those efforts have been severely undermined by AOL's studied indifference.

Despite AOL's lofty statements about the "generous licensing terms" it offers to anyone desiring access to AIM,[6] AOL's licensing behavior further demonstrates that competing companies, who are anxious to gain interoperability, cannot reach terms that AOL deems acceptable. Absent an interoperability condition on approval of the merger, AOL will continue to make its AIM technology available only to those competing providers that it does not consider threatening to its own dominant platform. The end result will be stifling of competition and innovation.

C. AOL's Distribution Arrangements

AOL's complete dominance of the IM market is further confirmed by its distribution arrangements with other content, product, and service providers and, in particular, its ISP competitors and next generation device manufacturers.

- AOL has a dominant position in the PC world and as a result has entered into distribution agreements with, among others, Apple, Lycos, Novell, EarthLink, and Lotus; it is difficult to imagine that AOL competitors such as EarthLink would ever consider using, for example, AOL-branded e-mail, but they have nonetheless

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AOL's IM licenses are likely to remain free because "[w]e believe that instant messaging is a feature, not a business, and we want to make that feature broadly available").

[6] *See Hearing on Interactive Television Before the House Subcomm. on Telecommunications, Trade, and Consumer Protection*, 106th Cong., at 45 (Sept. 27, 2000) (statement of Steven Case) (explaining that royalty-free licensing is "not just something we did with a few companies. It's something we've done with many companies, are eager to do with more companies").

determined that they must license AIM because it is the only viable long-term strategy to provide IM service in the AOL-dominated IM marketplace.[7]

- AOL, and AOL alone, has signed critically important deals with wireless providers to offer AIM on their services, including Sprint PCS,[8] NTT/DoCoMo,[9] OmniSky,[10] Motorola,[11] RIM (and its Blackberry device),[12] Nokia,[13] Arch Communications,[14] and BellSouth Mobility.[15] This development is particularly dangerous because IM is "hard wired" into these wireless devices, and downloading other IM services is not a possibility. The memory capacity of such devices will preclude coexistence of competing services. *It is our understanding that other IM competitor has entered into these types of arrangements.*

- In their October 19 *ex parte*, Applicants point to announcements by AT&T Wireless and Sprint PCS of new services that allow subscribers to utilize IM on their wireless phones as evidence of innovation in today's IM marketplace.[16] We disagree. This is evidence of leverage. As the articles and press releases attached to the October 19 *ex parte* explain, Sprint PCS has not entered into agreements with anyone other than AOL to use this innovative new platform. In other words, AOL is the only beneficiary of this new marketplace innovation.[17]

- AOL is moving beyond wireless platforms to leverage its reach further into new innovative areas through agreements with Kinko's, Net2Phone, Voyager.net, Oxygen Media, DigitalWork.com, RealNetworks, and TV Guide.[18]

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[7] *See* "AOL Announces Next Generation of AOL Instant Messenger - Version 4.0 - For Windows and Mac Users," *AOL Press Release* (Apr. 10, 2000) ("*AOL April 10 Press Release*").

[8] *See* "Sprint and America Online Launch the AOL Instant Messenger Service on the Sprint PCS Wireless Web," *AOL Press Release* (Oct. 19, 2000).

[9] *See* "NTT/DoCoMo and America Online Announce Strategic Alliance," *AOL Press Release* (Sept. 27, 2000).

[10] *See* "AOL and OmniSky to Offer 'AOL Wireless' Features and Content on OmniSky Wireless Internet Services," *AOL Press Release* (Sept. 5, 2000).

[11] *See AOL April 10 Press Release.*

[12] *See id.*

[13] *See id.*

[14] *See id.*

[15] *See id.*

[16] *See* October 19 *ex parte* at 3.

[17] *See, e.g.*, http://www.nytimes.com/2000/10/19/technology/19GEE1.html ("At 2 a.m. Central time, Sprint activated AOL Instant Messenger.").

[18] *AOL April 10 Press Release.*

Thus, AOL continues to expand its reach onto new platforms, compounding the network effects it enjoys now. Without interoperability by a date certain, the IM Competitors will be unable to close this ever-widening service gap, and many will eventually be forced to drop out of the race altogether.

2. Interoperability with AOL is a fundamental ingredient to success in the IM market.

IM is more than just an independent application or service – it is a vital distribution platform for any number of applications, services, and content.[19] As IM continues to increase rapidly in popularity, it has become essential to enable IM users to communicate seamlessly with one another. AOL certainly recognizes the importance of interoperability by seeking to make its two IM services – AIM and ICQ – interoperable.[20] IM Competitors regard interoperability as a fundamental assumption of effective participation in the IM marketplace.

- Odigo, a leading provider of private-label instant messaging solutions, identified interoperability as a critical ingredient to its success and continues to devote substantial resources to develop an interoperability standard.

- When AT&T WorldNet, a dial-up ISP service of AT&T Corp., introduced its IMHere service, it announced intermessaging with AOL, recognizing that interoperability with AOL was crucial to competitiveness.

- Tribal Voice, a Denver-based company, tried but was not successful in interoperating with AOL due to selective blocking by AOL.

- iCAST, based in the Boston suburb of Woburn, Massachusetts, testified before Congress that interoperability was a fundamental necessity to the success of its instant messenger, the iCASTER, and that AOL has not lived up to its public service commitments to interoperability.

IM interoperability is not only necessary to ensure existing IM Competitors survive; it also is necessary to encourage new companies to enter the IM marketplace.

- AOL's dominant position in the IM market and its intransigence on interoperability has what economists call "a shadow effect"– it scares away other entities who otherwise would invest their time and resources in the IM market, including venture capitalists; entrepreneurs; large companies, who are wary of devoting resources to a

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[19] *See, e.g.*, Notice of *Ex Parte* Presentation of Ross Bagully, Tribal Voice, and Margaret Heffernan, iCAST, in CS Docket No. 00-30, at 6 (Sept. 5, 2000).

[20] *See* Julia Angwin, "Instant Message Services at AOL Quietly Linked," Wall Street Journal, Sept. 26, 2000, at B1; *Ex Parte* Communication by Gerard J. Waldron, Covington & Burling, in CS Docket No. 00-30 (Oct. 5, 2000).

market they see as severely limited; and small companies, who cannot attract venture capital to a market that analysts see as blocked. Innovation suffers as a result.

- In a market dominated by a single player, the controlling IM provider has no incentive to interoperate with its competitors. Instead, by restricting the reach of the IM Competitors, AOL can reap all of the benefits of expanding IM to new platforms.

There can be little question that the diversity and number of IM applications will continue to grow only if potential IM competitors and partners believe their users can communicate freely and easily with other IM users. AOL's efforts to thwart interoperability among IM competitors thus stifles growth and innovation in the IM market by restricting the numbers of IM providers and the diversity of their offerings.

3. The proposed merger makes it much more likely that the market tipping in AOL's favor will become irreversible.

As we have discussed in our prior *ex parte* filings, the vertical nature of the merger – *i.e.*, the combination of AOL's IM distribution and Time Warner's content – enhances AOL's market power because it would require rivals to enter at two levels in order to compete, which is more costly and risky. In particular, the proposed merger would give AOL the incentive and the ability to make Time Warner's IM-enabled content (and related applications) exclusive to the AOL IM platform, thereby making AOL IM the only platform over which consumers can access all content and substantially raising IM rivals' costs by forcing two-level entry (in both IM and IM-enabled content/applications). Alternatively, AOL could require an IM provider to guarantee a certain number of "eyeballs" in return for access to the Time Warner content knowing that no other competitor would be able to fulfill that requirement. Thus, the vertical nature of the merger increases the danger that the market tipping in AOL's favor cannot be reversed by competition on the merits.

4. Lack of interoperability inconveniences millions of Americans.

AOL's October 19, 2000, *ex parte* goes to great lengths to identify the numbers of consumers that have been forced, due to a lack of IM interoperability, to register for and to use more than one IM service. This establishes one thing: *millions of Americans are being harmed by a lack of IM interoperability.*

- According to AOL, "45 percent of AIM active users reported using at least one other IM service," as if this is a desirable result.[21] This only demonstrates that millions of IM users are trying to figure their way out of a bad situation by using more than one IM service simultaneously.

- The fact that users have been forced to register for and use more than one IM service is evidence of a market failure and is certainly no reason to celebrate. It means that

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[21] October 19 *ex parte* at 2.

millions of IM users who desire and would benefit from interoperability are instead forced to resort to multiple IM services.

- This is the 21st Century version of a problem that plagued policymakers at the start of the 20th Century – a consumer who needs five phones on his desk to be able to communicate with his customers. Not a result the Commission or the public desires.

AOL next focuses on the size of a few IM Competitors to establish that the IM market is "robustly competitive." Although the size of some IM Competitors may be increasing, the number of their subscribers remains only a fraction of AOL's.

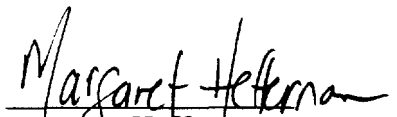
- While some customers may use AIM in combination with another IM service, almost no one is using a competing IM service without also using AIM.

- The fact that consumers can register for and use services offered by other IM Competitors proves nothing. Without interoperability, these other service offerings are practically worthless. It is similar to the equal access issue from the 1980s – dialing 23 numbers to reach another long distance provider does not offer consumers a real alternative.

* * *

For these reasons, it is essential that the Commission condition approval of Applicants merger on the parties' agreeing to implement IM interoperability by a date certain. Please direct any questions to the undersigned.

Sincerely,



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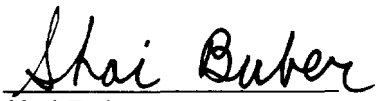

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